

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Alquist Analyst: Marion Mann DeJong Bill Number: AB 2741
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/25/2000
Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

SUBJECT: Water's-Edge Election Procedures

SUMMARY

This Franchise Tax Board (FTB) sponsored bill would fundamentally reform the water's-edge election procedures. Water's-edge elections would no longer be made by contract, but by statutory election.

EFFECTIVE/OPERATIVE DATE

The bill would be effective upon enactment and would apply for income years beginning on or after January 1, 2000. Water's-edge elections made under prior law would continue with the same commencement date as provided under the prior law.

PROGRAM HISTORY/BACKGROUND

California law allows a corporation to elect to calculate its income on a "water's-edge" basis, rather than a worldwide unitary basis. Throughout the history of the water's-edge election, statutory and regulatory amendments have been made in an attempt to provide relief for water's-edge election problems. The previous solutions have focused on providing relief for taxpayers that failed to satisfy the stringent requirements of the current election structure rather than reforming the way the water's-edge elections are made. However, the problems continue to occur. The following is a brief history of the problems and attempts to resolve them.

Because many electors inadvertently failed to comply with the statutory requirements for making a water's-edge election, legislation (SB 1805, Stats. 1994, Ch. 1243) was passed that added Section 18405 to the Revenue and Taxation Code (RTC). RTC Section 18405 provided a period for perfecting elections that were invalid because of unintentional noncompliance. This relief was limited to invalid elections made during the 1988 income year by taxpayers that subsequently requested relief within a specified period. However, election problems continued to occur after 1988.

RTC Section 18405 was amended (SB 887, Stats. 1995, Ch. 490) to address the situation where an election was invalid because all but one member of the water's-edge group made the election. Only one water's-edge group perfected its election under this legislation.

Board Position:

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Department Director

Date

Alan Hunter for GHG

3/22/00

In 1996 (SB 1870), and again in 1997 (AB 1469 and AB 1488), additional taxpayer-specific legislation was introduced to allow perfection of certain invalid elections. In response to this legislation, department staff recommended in 1997 that legislation be enacted to replace the contract requirement with a statutory election. However, such legislation was not pursued because the Franchise Tax Board and business community preferred a regulatory solution.

In 1998, California Code of Regulations (CCR) Sections 25111 and 25111.1 were amended to provide that a water's-edge election is valid even if a taxpayer failed to comply with procedural or statutory requirements, as long as there was substantial performance of the election requirements. A corporation is deemed to have substantially performed if its tax was computed consistent with a water's-edge election and other objective evidence demonstrates that the taxpayer intended to make the election. Generally, objective evidence is shown if the taxpayer files on a water's-edge basis and attaches any completed water's-edge forms to the original return.

The amendments made to the regulations resolved most of the election problems that had previously been identified. However, a substantial number of taxpayers have recently been identified as making potentially invalid elections that cannot be perfected under these regulations.

Further, the water's-edge election requirements are stringent, leave no margin for error, and do not grant FTB authority to allow invalid elections to be perfected. Because the election is made by contract between the taxpayer and the FTB, contract law principles must be applied alongside tax law principles, and the results are sometimes incompatible.

The provisions for renewal and nonrenewal of the water's-edge election term are complex. For example, many taxpayers currently file notices of nonrenewal in the first year of the election period to preserve the option to re-elect at the end of the seven-year contract term. Once a notice of nonrenewal is filed, the water's-edge election will terminate at the end of the seven-year period unless the taxpayer affirmatively files a new water's-edge contract. Unfortunately, taxpayers often overlook the requirement for filing a new contract.

The rules for carrying over a water's-edge election after subsequent acquisitions are inflexible and can give rise to unintended results. For example, if a purchaser is unaware that its newly acquired subsidiary has a water's-edge election in effect and fails to timely request a termination of that election, the purchaser's group will become subject to an election it did not intend to make. One small newly-acquired subsidiary can inadvertently cause a large group of corporations to become water's-edge for several years.

SPECIFIC FINDINGS

Under current federal law, corporations organized in the United States (U.S.) are taxed on all their income, regardless of source, and are allowed a credit for any taxes paid to a foreign country on their foreign source income.

Foreign corporations engaged in an U.S. trade or business are taxed at regular U.S. graduated corporate income tax rates on income effectively connected with the conduct of that business in the U.S. (This is known as effectively connected income, or ECI.)

However, foreign corporations are taxed at a flat 30% rate (or lower rate if provided by treaty) on specified types of fixed, determinable, annual or periodic income (usually investment income) from U.S. sources.

Under current California law, California source income for corporations that operate both within and without the state is determined using the unitary method of taxation. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of the income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales.

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. For purposes of determining the income of a corporate taxpayer that made a water's edge election, the income of certain corporations derived from sources within the United States is determined by federal income tax laws as applicable for federal purposes for the taxable period. In addition, certain federal rules and definitions, as applicable for federal tax purposes for the taxable period, regarding federal taxation of foreign income and entities, are used in connection with water's-edge determinations and computations although these same rules and definitions are not otherwise applicable for state tax purposes for the same taxable period. In consideration for being allowed to file on a water's-edge basis, the taxpayer must:

- Agree to file on a water's-edge basis for a period of seven years.
- Agree to business income treatment of dividends received from (1) over 50% owned entities engaged in the same general line of business as the members of the water's-edge group, or (2) entities that are a significant source of supply to or a significant purchaser of the output of the members of the water's-edge group. Significant means an amount equal to 15% or more.
- Consent to the taking of depositions from key employees or officers of the members of the water's-edge group and to the acceptance of subpoenas duces tecum requiring the reasonable production of documents.

The water's-edge election must be made *by contract* with FTB on the *original return* for the year and is effective only if *every taxpayer* that is a member of the water's-edge group and subject to California franchise or income tax makes the election. While the election was originally conditioned upon payment of a fee and the filing of a Domestic Disclosure Spreadsheet, those requirements were repealed in 1994.

An affiliated corporation that is either a member of the water's-edge group and subsequently becomes subject to tax, or a non-electing taxpayer that is subsequently proved to be a member of the water's-edge group pursuant to an FTB audit determination, is deemed to have elected water's-edge treatment. If a water's-edge taxpayer is acquired by another corporation pursuant to a corporate reorganization, the water's-edge election will carry over and be binding upon the acquiring corporation.

Each water's-edge contract is for an initial term of seven years and is automatically renewed each year for an additional one-year period unless written notice of nonrenewal is given by the taxpayer at least 90 days prior to the anniversary date.

If the taxpayer elects water's-edge and does not file a notice of nonrenewal, the election will continue indefinitely. If the taxpayer files a notice of nonrenewal, the election remains in effect for the balance of the period remaining on the original election or the last renewal of the election.

A water's-edge election may be terminated by a taxpayer prior to the end of the seven-year period if (1) the taxpayer is acquired directly or indirectly by a non-electing entity that alone or together with its affiliates included in a combined report is larger, in terms of equity capital, than the taxpayer, or (2) the taxpayer receives the permission of the FTB to terminate their election. A taxpayer seeking FTB permission to terminate an election must demonstrate that continuation of the water's-edge requirements would result in a significant disadvantage to the taxpayer and that such disadvantage is the result of an extraordinary or significant event that could not have been reasonably anticipated when the original election was made.

As a result of 1993 legislation that significantly modified California's treatment of water's-edge taxpayers, special rules applied to water's-edge contracts entered into for income years beginning prior to 1994. All contracts were rescinded with respect to any remaining contract periods on the first day of the taxpayer's income year that began before 1994. Therefore, all taxpayers wanting to continue to file on a water's-edge basis for 1994 had to make a new election.

This bill would fundamentally reform the water's-edge election procedures. Water's-edge elections would no longer be made by contract, but by statutory election. This would simplify the election process by eliminating the contract issues and the procedural requirements of executing a contract. The "substantial performance" concept currently in the regulations would be codified to prevent taxpayers that inadvertently fail to satisfy a procedural aspect of the election from losing their water's-edge status.

The renewal/nonrenewal provisions would be eliminated. Instead, a taxpayer that makes a water's-edge election would be required to request and receive permission from FTB to terminate the election within the first seven income years. However, the taxpayer could elect to return to a worldwide basis for any income year after the taxpayer has filed on a water's-edge basis for at least seven years. Likewise, after electing to return to a worldwide basis, the taxpayer would be required to file on a worldwide basis for at least seven income years before making another water's-edge election. However, the taxpayer could request and receive permission from the FTB to make a water's-edge election prior to the end of the seven-year period.

The acquisition rules would be reformed so that a water's-edge taxpayer would no longer automatically "taint" any non-electing affiliates with which it becomes unitary. Instead, when two or more taxpayers become unitary, the water's-edge election status of the larger taxpayer would prevail. This result is more likely to coincide with a taxpayer's expectations and would prevent a large combined reporting group from becoming unintentionally bound by a water's-edge election when it acquires a smaller water's-edge electing taxpayer.

Since provisions that would reform the water's-edge election procedures would be prospective, **this bill** would give FTB the authority to perfect elections that are not valid under current law.

This bill also would clarify that, unless otherwise specifically provided, for purposes of provisions related to water's-edge elections, the term "Internal Revenue Code" means provisions of Title 26 of the United States Code, as applicable for federal tax purposes for the taxable period. This provision effectively separates the normal annual "federal conformity" legislative process from the water's-edge provisions by ensuring that relevant changes to federal tax law applicable to water's-edge filers will be effectively "automatically" picked up in computing the income and deductions of the water's-edge group.

Policy Considerations

- Previous solutions to water's-edge election problems have focused on providing relief for taxpayers that failed to satisfy the stringent requirements of the current election structure. Despite those efforts, election problems continue to occur.

Reforming the water's-edge election procedures would simplify the election process by eliminating contract issues, overriding inconsistent filings by water's-edge group members, and reducing the potential for unintended elections when acquisitions occur. It would also eliminate the administrative burdens for both the taxpayer and the FTB associated with filing and tracking notices of nonrenewal and remove unintended consequences of nonrenewal.

- The requirement that the election be made by contract between the taxpayer and the FTB necessitates an analysis under both tax law and contract law (including the legal concepts of offer and acceptance and substantial compliance) to determine the validity of the election. The two bodies of law (tax, which generally requires strict statutory adherence, and contract, with its more generous admission of inferences drawn from facts and circumstances) are neither compatible nor complimentary. The water's-edge legislation initially used a contract because it was necessary to justify imposition of the requirement for a domestic spreadsheet and the water's-edge election fee. The repeal of the fee and the requirement of a domestic disclosure spreadsheet, effective January 1, 1994, eliminated the justification for the contract. No other apparent policy reason exists for retaining the contract requirement. If the water's-edge election were simply a tax election like any other (e.g., S corporation and installment sales), only tax law would be considered in determining the validity of the election and the mechanics of the election would be simplified.

Implementation Considerations

Implementation of this bill would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following order of magnitude revenue losses.

Estimated Revenue Impact of AB 2741 As Introduced February 25, 2000 [\$ In Millions]				
2000-01	2001-02	2002-03	2003-04	2004-05
None	none	*minor loss	(\$2)	(\$2)

* Minor loss is less than \$500,000. The proposal would be effective with income years beginning on or after January 1, 2000.

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of this bill would be determined by (1) the number of taxpayers with an invalid water's-edge election, (2) the tax differential between water's-edge and worldwide combined reporting for these taxpayers, and (3) the timing of when assessments would have been issued and their eventual collection, were it not for this bill.

Audit staff has identified 200 to 300 taxpayers with potentially invalid water's-edge elections that cannot be resolved by the recent regulatory amendments. The amount of additional taxes from placing these predominantly foreign parent taxpayers on a worldwide combined basis is unknown. For a small sample of these taxpayers, tax returns were examined for purposes of determining an order of magnitude estimate. The cursory examination indicated that foregone assessments could be on the order of \$5 million in additional tax for all open tax years. The timing of when assessments would otherwise have been issued and the eventual collection of additional taxes assessed plus interest is speculative. For this estimate, it is assumed that the vast majority of assessments would otherwise have been issued during 2001 and 2002. It is further assumed that eventual collection would have been delayed two to four years after that.

BOARD POSITION

Support.

The Franchise Tax Board voted at its December 16, 1999, meeting to sponsor this legislation.